

The Use Of Arbitration In Director and Officer Indemnification Disputes

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“He will win who knows when to fight and when not to fight.”¹

I. INTRODUCTION

The indemnification of corporate directors and officers is universally accepted as an important element of corporate governance.² Director and officer indemnification provides reimbursement to the indemnified party from its corporate employer for liabilities, including amounts incurred because of adverse judgments, settlement payments, attorney’s fees and other legal expenses arising out of their service to the corporation.³

Corporate director and officer indemnification has been a prominent part of corporate governance for over fifty years in an effort to encourage qualified and talented individuals to serve as directors and officers without the fear of personal legal liability for their corporate decisions.⁴ Inevitably,

¹ SUN TZU, THE ART OF WAR 17 (James Clavell ed., Dell Publishing 1988).

² All 50 states have statutes that allow for the indemnification of corporate directors and officers. See WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 497-499 (Cum. Supp. 1996).

³ See Dennis J. Block et al., *Indemnification and Insurance of Corporate Officials*, 623 PLI/Comm. 403, 412 (1992).

In addition to corporate directors and officers, in most jurisdictions, even other employees or agents may seek corporate indemnification for legal expenses they incur because of their official actions. See *id.*

⁴ See, e.g., 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 282 (5th ed. 1993). A 1941 New Jersey court stated that indemnification would aid in inducing “responsible business men to accept post of directors.” *Id.*

Indeed, in 1986 a rash of corporate director resignations and refusals to serve on boards was attributed to “[c]oncern[s] about increasing legal hassles . . .” Laurie Baum & John A. Byrne, *The Job Nobody Wants: Outside Directors Find that the Risks and Hassles Just Aren’t Worth It*, BUS. WK., Sept. 8, 1986, at 56.

More recently, some Silicon Valley corporate directors expressed that they may resign their positions if California voters approved Proposition 211. The legislation included provisions that would have held directors liable, while simultaneously prohibiting their corporate employers from indemnifying them in some class action

intracorporate disputes arise between executive employees and the corporation as to whether the employee's conduct has met statutory or contractual thresholds that entitle the employee to indemnification.⁵

As the expenses of litigating corporate director and officer claims continue to rise,⁶ public corporations⁷ should utilize arbitration⁸ to settle director and officer indemnification disputes to offset some of the increasing costs. Public corporations' use of arbitration in indemnification disputes would be consistent with the evolving history of using methods of alternative dispute resolution (ADR) to decide intracorporate conflicts.⁹

suits. *See* Ted Pincus, *Rule of Law: Pass Proposition 211 and Watch the Market Fall*, WALL ST. J., Oct. 30, 1996, at A23.

⁵ *See, e.g.*, *Mayer v. Executive Telecard, Ltd.*, No. 95 Civ. 5403 (BSJ), 1997 WL 16669 (S.D.N.Y. Jan. 17, 1997).

⁶ The average cost of defending director and officer claims is over \$900,000. The actual cost is even more substantial because significant costs are absorbed by in-house counsel also involved in defending the claims. *See* WATSON WYATT, D & O LIABILITY SURVEY REPORT 48 (1995).

⁷ Public corporations can be contrasted with close corporations. There are four basic differences between public corporations and closely held corporations: (1) public corporations often have a large number of shareholders with no relationship to each other besides their ownership shares in the corporation, while close corporations are generally controlled by small, tightly knit groups of investors or owners; (2) public corporations have limited participation by the shareholders, but rely on active, specialized management by business executives, while close corporation investors or owners actively participate in management; (3) public corporation investors are concerned about receiving a return on their investment through appreciation of their stock, while close corporation participants often rely on the corporation as a primary means of support through either salaries or dividend payments; (4) public corporations participate in public trading markets which allow shareholders to easily transfer their shares. Close corporations do not have publicly traded shares and sometimes have contractual agreements among the investors or owners to limit the transfer of shares. *See* LEWIS D. SOLOMON & ALAN R. PALMITER, *CORPORATIONS: EXAMPLES AND EXPLANATIONS* § 15.1 at 206 (2d ed. 1994).

⁸ Arbitration is a private dispute resolution procedure that typically includes all of the essential elements of court adjudication except pretrial discovery. Most private arbitration provides for joint selection of arbitrators, objective standards for arbitrators to base their decisions upon and procedural rules to be applied by the arbitrators. *See* STEPHEN B. GOLDBERG ET AL., *DISPUTE RESOLUTION: NEGOTIATION, MEDIATION, AND OTHER PROCESSES* 199-200 (2d ed. 1992).

⁹ Public corporations have historically relied heavily on arbitration in resolving labor relations disputes. One commentator estimates that from 1961 to 1962, 94% of all

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Part II of this Note presents a brief overview of director and officer indemnification, as well as the problems that arise by resolving these conflicts through litigation. Part III of this Note discusses the further judicial acceptance and expansion of ADR in intracorporate disputes as recently evidenced by a federal court in the case of *In re Salomon Inc. Shareholders' Derivative Litigation*.¹⁰ Part IV of this Note illustrates how corporations may adopt arbitration provisions for indemnification disputes with their executives through bylaw or charter amendments, or through contractual indemnity agreements. Part V discusses the benefits of arbitrating director and officer indemnification disputes over litigating such conflicts. Part VI of this Note provides a model indemnification-arbitration provision. Part VII of this Note concludes that under the analysis of the *Salomon* court, indemnification-arbitration provisions would be enforced by courts and should be utilized by public corporations.

II. CORPORATE OFFICER & DIRECTOR INDEMNIFICATION

Since the 1940s and the 1950s, courts have recognized the importance of corporations protecting their executives from personal liability for the discharge of their corporate offices.¹¹ Following judicial recognition and acceptance of a public policy favoring corporate director and officer indemnification, both corporations and their executives increasingly sought to utilize the shelter provided by corporate indemnification as a critical element of effective corporate management.¹²

collective bargaining agreements between corporations and organized labor contained some type of arbitration clause. *See* David E. Feller, *A General Theory of the Collective Bargaining Agreement*, 61 CAL. L. REV. 663, 747 (1973).

In the late 1980s, publicly owned security brokers began to dramatically increase the use of arbitration in customer disputes. The National Association of Securities Dealers reported that more than 4000 arbitration cases were filed in 1988, compared with 2886 cases being filed in 1987. *See Business Bulletin*, WALL ST. J., Dec. 22, 1988, at A1.

¹⁰ Fed. Sec. L. Rep. (CCH) ¶ 98,454 (S.D.N.Y. Sept. 25, 1994).

¹¹ *See, e.g.,* Solimine v. Hollander, 19 A.2d 344 (N.J. Ch. 1941); *In re E.C. Warner Co.*, 45 N.W.2d 388, 393 (Minn. 1950) (finding that reimbursement of legal expenses for corporate officials is necessary for the purpose of establishing a "sound public policy favorable to the development of sound corporate management as a prerequisite for responsible corporate action").

¹² *See* Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 574 (1996). "[C]ourts began to realize that a key ingredient to effective corporate management was the protection of corporate officials from personal liability.

The indemnification of directors and officers is an important element in corporate culture and continues to flourish as accepted public policy. Indeed, since New York enacted the first director and officer indemnification statute in 1941, all fifty states, as well as Puerto Rico and the Virgin Islands, have approved indemnification statutes.¹³ One court has stated that these statutes were important "to assure corporate officials that they will not be hampered by financial constraints in mounting a full defense against unjustified suits."¹⁴

State indemnification statutes vary in many respects. Some state provisions require indemnification only when the executive is "wholly successful" on the merits,¹⁵ while other statutes require indemnification only to the extent that the executive "has been successful on the merits."¹⁶ In addition to variances as to when executives receive indemnification, statutes vary regarding the types of legal proceedings that require indemnification and the amounts for which executives may be indemnified.¹⁷

Although state indemnification statutes differ, they can broadly be categorized as providing two types of indemnification—mandatory and permissive.¹⁸ Mandatory indemnification requires that corporations reimburse the indemnified parties when they are successful in defending proceedings brought against them.¹⁹ Permissive indemnification refers to

Accordingly, corporate officials vigorously began to pursue the protection of corporate indemnification and corporations responded by seeking the power to indemnify their directors and officers." *Id.*

¹³ See 2 KNEPPER & BAILEY, *supra* note 4, at 283. Not only have all 50 states enacted director and officer indemnification provisions, but since the 1980s some states have amended their indemnification statutes to "liberalize and expand" director and officer indemnification. *Id.*

¹⁴ *McLean v. International Harvester Co.*, 902 F.2d 372, 375 (5th Cir. 1990).

¹⁵ N.C. GEN. STAT. § 55-8-52 (1990).

¹⁶ DEL. CODE ANN. tit. 8, § 145(c) (1991). This statutory language has been interpreted as requiring indemnification for successful claims, even if the executive was unsuccessful in defending other claims. See Monteleone & Conca, *supra* note 12, at 576.

¹⁷ See Monteleone & Conca, *supra* note 12, at 577-580.

For a complete inspection of all state statutory variances, see KNEPPER & BAILEY, *supra* note 2.

¹⁸ See Monteleone & Conca, *supra* note 12, at 574-575.

¹⁹ See *id.* at 575-576.

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situations where the corporation is not *required* to provide indemnity, but *may* exercise the power to indemnify.²⁰

Even with the extensive statutory guidance, as well as corporations' assimilation of indemnification provisions into their bylaws or executive employment agreements,²¹ disputes often arise between executives and their corporate employers regarding their right to be indemnified.²² A representative intracorporate indemnification dispute arose in the recent case of *Mayer v. Executive Telecard, Ltd.*²³ Theodore Mayer, the former corporate treasurer of Executive Telecard, Ltd., sought indemnification for attorney's fees and other expenses he had incurred in defending an action brought against him in his corporate capacity.²⁴ Executive Telecard refused to provide indemnification because it did not believe Mayer had been successful on the merits in the underlying claim.²⁵ Mayer was then forced to sue the corporation in order to obtain indemnification for the costs he incurred in defending the claim against him.²⁶

Indemnification litigation between corporations and their executive employees costs the corporation both time and money that could likely be saved by submitting these conflicts to arbitration.²⁷ Further, intracorporate

²⁰ See *id.* at 576.

²¹ See 2 KNEPPER & BAILEY, *supra* note 4, at 627-633.

²² See, e.g., *Witco Corp. v. Beekhuis*, 38 F.3d 682 (3d Cir. 1994) (holding that all Delaware corporations must comply with state statutory provisions regarding mandatory indemnification); *Sequa Corp. v. Gelmin*, 828 F. Supp. 203 (S.D.N.Y. 1993) (discussing a former executive suing corporation to receive advances for litigation expenses incurred in defending the corporation's civil, Racketeer Influenced & Corrupt Organizations Act (RICO) and state claims against him); *Dalany v. American Pac. Holding Corp.*, 42 Cal. App. 4th 822 (Cal. Ct. App. 1996) (seeking judicial determination of whether executives had been successful on the merits in their claim and thus entitled to indemnification); *Plate v. Sun-Diamond Growers of California*, 225 Cal. App. 3d 1115 (Cal. Ct. App. 1990) (stating that employees failed to secure indemnification for a judgment obtained against them for inducing the corporation to breach its commodities brokerage contract); *Kaufman v. CBS, Inc.*, 514 N.Y.S.2d 620 (N.Y. Civ. Ct. 1987) (attempting unsuccessfully to receive indemnification for federal employment discrimination claims).

²³ No. 95 Civ. 5403 (BSJ), 1997 WL 16669 (S.D.N.Y. Jan. 17, 1997).

²⁴ See *id.* at *1.

²⁵ See *id.* at *2.

²⁶ See *id.* at *3.

²⁷ See G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C. L. REV. 517, 521 (1989). "Arbitration is generally thought to be cheaper, faster, and more flexible than litigation as a means of resolving commercial disputes." *Id.*

Further, the simplest securities civil case often takes up to four years to resolve through litigation. In comparison, according to the Securities Industry Council on

indemnification disputes swallow energy and resources resulting in direct opposition to the general objectives of a corporation to conduct business activities "with a view to enhancing corporate profit and shareholder gain."²⁸

A great deal is at stake in determining either the right to indemnification or the absence of a corporate obligation to indemnify because of the enormous costs of defending claims brought against corporate officers and directors.²⁹ Claims against directors and officers will likely continue to arise,³⁰ but some of the burden of the costs of these actions borne by the corporation,³¹ and inevitably by the shareholders, could be eased by submitting intracorporate disputes regarding director and officer indemnification rights to arbitration.

Litigating indemnification disputes also places a tremendous burden on executives. While waiting for judicial determinations as to their right to be indemnified, their legal costs and other expenses involved in defending claims against them will continue to mount. Thus, the executive is in a situation similar to an executive who is covered by an indemnification insurance policy that does not provide for the advancement of defense expenses—he is forced to initially support a defense with personal resources.³²

Arbitration, most securities disputes submitted to arbitration are disposed of in the same year they are filed. See G. Richard Shell, *Keep Broker-Client Disputes Out of Court*, WALL ST. J., March 3, 1987, at B1.

²⁸ THE AMERICAN LAW INSTITUTE PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 2.01(a), at 69 (Proposed Final Draft March 31, 1992).

²⁹ See WATSON WYATT, *supra* note 6, at 48.

³⁰ See *id.* at 42.

³¹ Corporations do not usually directly pay indemnification expenses, but they often provide insurance to cover the costs. All 50 states expressly allow corporations to purchase director and officer indemnification insurance to cover the expenses of claims. See KNEPPER & BAILEY, *supra* note 2, at 497-499. For an extensive discussion of director and officer indemnification insurance, see Block et al., *supra* note 3, at 430-482. See also 2 KNEPPER & BAILEY, *supra* note 4, at 335-385.

³² Indemnification insurance that does not provide for advancement of expenses is problematic for the insured executive. "Where defense expenses reach the hundreds of thousands of dollars, and perhaps millions of dollars, it creates a tremendous financial strain upon an insured to have to pay these expenses and then await reimbursement from the insurer." Monteleone & Conca, *supra* note 12, at 595.

III. *IN RE SALOMON INC. SHAREHOLDERS' DERIVATIVE LITIGATION*

Courts are willing to enforce arbitration provisions to settle disputes in legal areas where ADR is a novelty. *Salomon* is an example of the continued expanding judicial acceptance of utilizing arbitration to resolve disputes that have traditionally been the exclusive domain of full-scale litigation.³³ The case represents the judiciary's initial approval of arbitration as an alternative to litigation in resolving a public shareholder derivative suit.³⁴

In the fall of 1991, Salomon Inc. disclosed that its subsidiary, Salomon Brothers Inc., violated federal securities laws in two ways. Salomon Brothers had done the following: (1) bid for and acquired United States debt securities issued at a Treasury Department auction in excess of the thirty-five percent limitation set by the Treasury; and (2) certain Salomon and Salomon Brothers senior executives had known of the Treasury Department auction misconduct, but failed to report the incident to the appropriate regulatory authority, and took no action to discipline the employees responsible for the bidding misconduct or to prevent future bidding violations.³⁵

A group of Salomon shareholders brought a derivative action against several directors and officers,³⁶ and one Salomon employee.³⁷ The derivative shareholder plaintiffs sought to recover at least \$326,200,000 on claims that included assertions that the individual defendants had violated securities laws, broken bidding rules and regulations of the Treasury Department and Federal Reserve, and that Gutfreund, Strauss and Meriwether had breached their fiduciary duties in their capacities as corporate officers and directors.³⁸

³³ See Jeffrey A. Sanborn, Note, *The Rise of "Shareholder Derivative Arbitration" in Public Corporations: In re Salomon Inc. Shareholders' Derivative Litigation*, 31 WAKE FOREST L. REV. 337, 337 (1996).

³⁴ See *id.* Shareholder derivative actions are the primary means for shareholders to hold corporate officers and directors accountable for fiduciary duties. Typically, the shareholders, who are the derivative suit plaintiffs, sue on behalf of the corporation to enforce the corporation's rights. The corporation itself is an indispensable party in a derivative action and is made a nominal defendant. See *SOLOMON & PALMITER*, *supra* note 7, §§ 31.1-31.1.1, at 479-480.

³⁵ See *Salomon*, Fed. Sec. L. Rep. (CCH) 98, 454, at 91,116.

³⁶ John H. Gutfreund and Thomas W. Strauss served as directors of both Salomon and Salomon Brothers. John Meriwether was a director for Salomon Brothers. See *id.*

³⁷ Paul Mozer was the Salomon employee who allegedly participated in the bidding misconduct. See *id.*

³⁸ See *id.* at 91,116.

The individual defendants sought to compel arbitration of the claims under the constitution and rules of the New York Stock Exchange (NYSE).³⁹ The district court concluded that Salomon Brothers and each of the individual defendants were either covered members or allied members of the NYSE,⁴⁰ and had executed written agreements to abide by the constitution and rules of the NYSE, including provisions regarding arbitration.⁴¹ With regard to arbitration, Article XI, section 1 of the NYSE Constitution provides in relevant part that:

Any controversy between parties who are members, allied members or member organizations and any controversy between a member, allied member or member organization and any other person arising out of the business of such member, allied member or member organization . . . shall at the instance of any such party be submitted for arbitration in accordance with the provisions of this Constitution and [NYSE rules].⁴²

Further, Rule 347 of the NYSE provides that:

Any controversy between a registered representative and any member or member organization arising out of the employment or termination of employment of such registered representative by and with such member or member organization shall be settled by arbitration, at the instance of any such party, in accordance with the arbitration procedure prescribed elsewhere in these rules.⁴³

The *Salomon* court found that these NYSE provisions, when considered against the backdrop of a strong federal policy favoring arbitration embodied in the Federal Arbitration Act (FAA),⁴⁴ were reason to grant the individual defendants' motion to compel arbitration.⁴⁵

³⁹ See *Salomon*, Fed. Sec. L. Rep. (CCH) ¶ 98,454, at 91,115-91,116.

⁴⁰ *Salomon* was not a member of the NYSE, nor had the corporation executed any written agreement to abide by the NYSE's constitution or rules. However, the court found that *Salomon* was also bound by the NYSE provisions regarding arbitration because it was sufficiently "thoroughly enmeshed in the underlying dispute in the case at hand" *Id.* at 91,119.

⁴¹ See *id.* at 91,117.

⁴² *Id.* (alterations in original).

⁴³ *Id.*

⁴⁴ 9 U.S.C. §§ 1-16 (1982).

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The court further found that the following two elements were determinative of whether a claim should be submitted to arbitration: (1) whether the parties agreed to arbitrate disputes; and (2) whether there were legal constraints external to the parties' agreement that should foreclose arbitration.⁴⁶

On its face, the court's conclusion in *Salomon* does not appear to be extraordinary considering the clear language of Article XI, section 1 of the NYSE Constitution, NYSE Rule 347 and the FAA. However, the court's determination that shareholder derivative actions did not present situations in which arbitration agreements should be foreclosed because of external legal constraints is an important development in the further acceptance of arbitration to resolve intracorporate disputes of public corporations.⁴⁷

A. Arbitration in Public Corporation Shareholder Derivative Litigation

Arbitration has historically been viewed as an unacceptable means of resolving public shareholder derivative claims because of the legal theory relating to the necessity of the states maintaining control over large corporations.⁴⁸ The ability of shareholders to bring derivative suits against corporate directors and officers to exert corporate rights, and to resolve these claims through the judicial process, has an important position in

The district court found several important provisions of the FAA relevant to the disposition of *Salomon*. See *Salomon*, Fed. Sec. L. Rep. (CCH) ¶ 98,454, at 91,117–91,118.

The court recognized that the purpose of the FAA was to treat agreements to arbitrate with the same validity and force as other contracts:

The FAA accomplished this purpose by providing that arbitration agreements “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.” 9 U.S.C. § 2. The FAA also provides that a court must stay its proceedings if it is satisfied that an issue before it is arbitrable under the agreement, § 3 [sic]; and it authorizes a federal district court to issue an order compelling arbitration if there has been a ‘failure, neglect, or refusal’ to comply with the arbitration agreement, § 4 [sic].

Id. at 91,117 (alterations in original).

⁴⁵ See *id.* at 91,123.

⁴⁶ See *id.* at 91,118.

⁴⁷ See generally Sanborn, *supra* note 33.

⁴⁸ See Shell, *supra* note 27, at 534.

corporate governance.⁴⁹ Shareholder derivative actions allow the judiciary to develop corporate rules of law that are effective in the regulation of both public corporations and their executives.⁵⁰ Therefore, the idea has been that public shareholder derivative actions need judicial resolution to continue the development of corporate management duties.⁵¹

In addition to the concern that the judicial process was necessary in public derivative suits to further develop management duties, arbitration of these claims has traditionally been rejected because of a reluctance to bind public shareholders to an arbitration agreement contained in either the corporation's charter or even its shareholder agreement.⁵² The troubling question has been whether an arbitration provision regarding derivative claims, or any other intracorporate claim, contained in a corporation's charter would constitute a binding contract on shareholders under the FAA.⁵³

⁴⁹ See *id.* In addition to derivative claims, shareholders in public corporations also have the capacity to vote in corporate elections to influence management decisions. However, some believe that the idea of corporate democracy that is created by shareholder voting is a myth because public shareholders are a dispersed group and therefore have a difficult time combining their votes in an effective way. See *id.* at 536.

⁵⁰ See *id.* Public shareholder derivative actions are often brought to recover for alleged director and officer breaches of their fiduciary duty of care or duty of loyalty. "Virtually the only source of cases that give operational meaning to these fiduciary standards are judicial opinions rendered in response to shareholder lawsuits against management." *Id.* at 537-538.

⁵¹ See *id.* at 541. In addition to the desire to further management duties by using the judicial forum to resolve public shareholder derivative claims, several other factors historically appeared to make arbitration of derivative claims an impossibility. Derivative actions often include allegations of violations of federal securities laws, and until 1987, arbitrators had no authority with regard to these claims. Also, prior to 1984, state courts applied state statutory rules to arbitration agreements, and all state arbitration laws relating to corporate governance were limited to close corporations. Finally, state statutes that govern derivative actions require judicial approval of any settlement or dismissal. See *id.* at n.151 (citations omitted).

⁵² See *id.* at 544-551. The judicial forum and contract concerns are not the only traditional problems with the arbitration of derivative claims, but they are of primary importance with relation to this Note. For more complete discussions of arbitration and derivative actions see John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988); Sanborn, *supra* note 33; Shell, *supra* note 27

⁵³ See Shell, *supra* note 27, at 544-551.

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Even if one concedes that an arbitration agreement in a corporation's charter is indeed a binding contract provision, there remains the issue of the shareholders' acceptance of the provision through their purchase of stock.⁵⁴ Membership as a shareholder in a public corporation is unlike other memberships because public shareholders do not share professional, personal or religious interests that would imply their willingness to be subject to the organizational norms that accompany their membership. It is difficult to infer the consent of literally millions of public shareholders to an arbitration provision solely because they have all decided to purchase the same stock.⁵⁵

The passive nature of public stock ownership ensures that many shareholders will be unaware of any arbitration provision when they purchase their shares. Further, arbitration provisions have not been widely used in resolving public corporation shareholder disputes.⁵⁶ These two issues, combined with the perceived superior bargaining power of the corporation to amend corporate charters, may create the requisite adhesion, surprise and disparate bargaining power that could yield an arbitration provision unconscionable under contract law.⁵⁷

The district court in *Salomon* considered both the need for judicial determinations in public derivative claims and the effect of binding public shareholders to arms-length arbitration provisions, and concluded that arbitration was an acceptable and agreed-upon mechanism for resolving the shareholder derivative claims at bar.⁵⁸

⁵⁴ See *id.* at 547.

⁵⁵ See *id.*

⁵⁶ See *id.* at 549.

⁵⁷ See *id.* If an agreement to arbitrate is unconscionable, it is not subject to the realm of the FAA. "An agreement in writing to submit to arbitration an existing controversy . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (1982).

⁵⁸ See *Salomon*, Fed. Sec. L. Rep. (CCH) ¶ 98,454, at 91,123.

1. *Need for Judicial Determination*

The *Salomon* court recognized the traditional sound public policy disfavoring the arbitration of public shareholder derivative suits.⁵⁹ However, the court reasoned that under the FAA and a United States Supreme Court ruling, it was required to enforce an arbitration agreement between the parties absent some Congressional intent to preclude a cause of action from alternative means of dispute resolution.⁶⁰

The court considered, and rejected, the argument that Congress had intended to preclude the waiver of judicial remedy in shareholder derivative actions by promulgating Federal Rule of Civil Procedure 23.1.⁶¹ Rule 23.1 provides in pertinent part that “[derivative actions] shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders . . . in such manner as the court directs.”⁶²

The court found that Rule 23.1 is not a statute enacted by Congress requiring judicial involvement in shareholder derivative disputes, but is instead a procedural right and duty that is binding upon the courts. However, the court is forced to yield to substantive statutory rights such as those embodied in the FAA.⁶³

Thus, even though it harbored “considerable doubt as to the suitability of arbitration” in shareholder derivative actions, the court correctly

⁵⁹ See *id.* at 91,119–91,120. “Courts have long recognized the importance of the shareholders’ derivative form of action as a means of ensuring corporate management in the interests of the shareholders and redressing abuses of trust by corporate officers and directors.” *Id.* See also *supra* notes 48–58 and accompanying text.

⁶⁰ See *Salomon*, Fed. Sec. L. Rep. (CCH) ¶ 98,454, at 91,120. The court cited *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 627 (1985), which stated that:

[j]ust as it is the congressional policy manifested in the Federal Arbitration Act that requires courts liberally to construe the scope of arbitration agreements covered by that Act, it is the congressional intention expressed in some other statute on which the courts *must* rely to identify any category of claims as to which agreements to arbitrate will be held unenforceable.

Salomon, Fed. Sec. L. Rep. ¶ 98,454, at 91,120 (emphasis added by the court).

⁶¹ See *Salomon*, Fed. Sec. L. Rep. (CCH) ¶ 98,454, at 91,120–91,121.

⁶² FED. R. CIV. P. 23.1.

⁶³ See *Salomon*, Fed. Sec. L. Rep. (CCH) ¶ 98,454, at 91,120–91,121.

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recognized that arbitration was a favored dispute resolution mechanism and enforced the parties' agreement.⁶⁴

2. Binding Shareholders to NYSE Arbitration Provisions

The district court found that the shareholder plaintiffs in a derivative action were indeed obligated by the arbitration provisions that bound the corporation.⁶⁵ The court reasoned that in derivative actions the shareholders' claims are not actually theirs, but are instead the claims of the corporation.⁶⁶

Derivative shareholder plaintiffs assume the rights of the corporation. Thus, those sued by a shareholder plaintiff may utilize all defenses or procedures they could utilize against the corporation.⁶⁷ The *Salomon* court found that the shareholders who brought the derivative action against the individual defendants were committed to the NYSE arbitration provisions because the defendants chose to employ the provisions.⁶⁸

Therefore, because the corporation itself would be committed to arbitrate the disputes at the insistence of a party under the NYSE's Constitution and Rules, the derivative shareholders were also bound to arbitration upon demand of the defendants.

B. Arbitration in Director and Officer Indemnification Disputes

The district court was correct to enforce the NYSE arbitration provisions in the public shareholder derivative action involved in *Salomon*. Therefore, if corporations provide for the arbitration of indemnification disputes with their executives, courts should enforce those agreements.

⁶⁴ *Id.* at 91,121. The court quoted the United States Supreme Court that "any doubt concerning the scope of arbitrable issues should be resolved in favor of arbitration." *Id.* (quoting *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24–25 (1982)).

⁶⁵ *See id.* at 91,118.

⁶⁶ *See id.* "It is well established that a 'claim pressed by the stockholder against directors or third parties is not his (or her) own but the corporation's.'" *Id.* (quoting *Ross v. Benard*, 396 U.S. 531, 538 (1970)).

⁶⁷ *See id.*

⁶⁸ *See id.* at 91,118–91,119.

1. *No External Legal Constraints Preclude Arbitration of Indemnification Disputes*

Intracorporate director and officer indemnification disputes provide less challenging concerns regarding public policy and external legal constraints than do public shareholder derivative actions.⁶⁹ Indemnification disputes can be resolved through arbitration, yet still allow for judicial conclusions with regard to executive standards and duties through the underlying action for which the executive seeks indemnification. Thus, even if the parties agree to exclude the judiciary from determining the executive's right to indemnification, corporate duties may continue to be further defined by courts through resolution of the original action that caused the director to become a party in need of indemnification.

The United States Supreme Court has held that under the FAA, agreements to arbitrate should be enforced according to the agreement of the parties unless Congress has acted to require judicial adjudication of a claim.⁷⁰ The *Salomon* court considered the effect that Federal Rule of Civil Procedure 23.1 may have in precluding the arbitration of derivative actions, and decided that the Rule does not forbid the arbitration of such claims.⁷¹

Agreements to arbitrate intracorporate indemnification disputes would survive similar scrutiny to determine whether Congress has acted to preclude the arbitration of the claims because to date Congress has acted in no way to limit the means of resolving indemnification disputes.

⁶⁹ See *supra* notes 48-68 and accompanying text.

⁷⁰ See *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985) (finding that a claim is nonarbitrable only when "Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue").

The Court has not shied away from its commitment to arbitration, but has further embraced it. In a 1995 case, the Court allowed a plaintiff to recover punitive damages from a securities broker based on the parties' client agreement arbitration provision, even though New York law precludes arbitrators from granting punitive damages. See *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 58-64 (1995). The Court found that its ruling was "consistent with the central purpose of the Federal Arbitration Act to ensure 'that private agreements to arbitrate are enforced according to their terms.'" *Id.* at 53-54 (quoting *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 479 (1989)).

⁷¹ See *Salomon*, Fed. Sec. L. Rep. ¶ 98,454, at 91,120-91,121.

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Therefore, because the *Salomon* court found that there were no legal constraints external to the parties' agreement to arbitrate that would foreclose arbitration in public corporation derivative actions, it would be legally acceptable for courts to enforce intracorporate indemnification arbitration agreements.⁷²

*2. Indemnification Arbitration Agreements Would Present No Contractual Problems*⁷³

In *Salomon*, the district court found a valid agreement to arbitrate disputes based on the NYSE Constitution Article XI, section 1 and Rule 347.⁷⁴ The derivative plaintiff shareholders were held to these provisions because the court found that the plaintiffs stood in the shoes of Salomon and Salomon Brothers, who would as members of the NYSE be obligated to arbitrate under the NYSE Rules.⁷⁵ The court bound the derivative shareholders despite historical concerns regarding the conscionability of enforcing broad corporate provisions against vastly dispersed shareholders.⁷⁶

The executives who would be parties to an intracorporate indemnification arbitration agreement are even more attractive and acceptable candidates to be bound by corporate contractual provisions than public corporation derivative shareholder plaintiffs. Corporate executives are generally highly trained and educated professionals.⁷⁷ They are often involved in the daily operations of the corporation and exert a great deal of influence over corporate decisions.⁷⁸ These individuals are in a much

⁷² See *id.* at 91,119–91,124.

⁷³ For a discussion of how corporations and their executives may commit to arbitrating indemnification disputes, see *infra* Part IV.

⁷⁴ See *Salomon*, Fed. Sec. L. Rep. ¶ 98,454, at 91,117–91,119.

⁷⁵ See *id.* at 91,118.

⁷⁶ See Coffee, *supra* note 52, at 963–967; Shell, *supra* note 27, at 543–549.

⁷⁷ A 1985 survey revealed that 93% of the directors of major American companies were white males who had graduated from college. James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 106 n.107 (Summer, 1985). The directors tended to be chief executive officers, university presidents and deans, attorneys and former government officials. With increasing expectations for corporate board performance, it is anticipated that corporate management will become even more professional and specialized in the future. See Ira M. Millstein, *The Professional Board*, 50 BUS. LAW. 1427, 1440–1441 (1996).

⁷⁸ See generally Millstein, *supra* note 77.

stronger position to be aware of corporate charter provisions and corporate dispute resolution procedures than the average public shareholder.

Because the *Salomon* court found that the NYSE's Constitution and Rules were adequate to bind public shareholder plaintiffs in the derivative action, courts should enforce agreements to arbitrate corporate indemnification disputes because the corporate executives have a far more intimate relationship to the corporation's organizational norms and procedures than most shareholders.

IV. METHODS OF INCLUDING INDEMNIFICATION ARBITRATION PROVISIONS

Corporations should assess the likelihood that their directors and officers will be subject to claims in deciding whether it would be beneficial to include arbitration provisions in indemnification agreements. Executives of larger public corporations are most susceptible to suits, and it would be more efficient and prudent for large corporations to arbitrate intracorporate disputes regarding executive indemnification rights than to absorb the costs of litigating these issues.⁷⁹ Once a corporation has determined its needs and the benefits of arbitrating executive indemnification disputes, there are several methods that the corporation can utilize to employ arbitration provisions.

A. Indemnity Agreements

Public corporations have indemnity agreements with their top executives.⁸⁰ These agreements determine the scope, limitations and necessary procedures for a director or officer to receive indemnification.⁸¹ Corporations could utilize arbitration in indemnification disputes by including an arbitration provision in their executive indemnity agreements.

⁷⁹ Directors of corporations with assets over \$10 billion are far more susceptible to claims, and are sued with far greater frequency than directors of corporations with under \$100 million in assets. *See* WATSON WYATT, *supra* note 6, at 42. Also, directors of corporations involved in large banking, utilities, transportation and communication, nonbanking financial services and petroleum, mining and agriculture are likely to be sued with greater frequency than their counterparts in other business classes. *See id.* at 43.

⁸⁰ *See, e.g.*, 2 KNEPPER & BAILEY, *supra* note 4, at 631-633.

⁸¹ *See id.*

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The utilization of an arbitration provision in a corporate indemnity agreement is consistent with the use of arbitration clauses in other corporate executive agreements, such as restricted stock agreements and resignation agreements.⁸²

The First Commerce Corporation of Louisiana provides for the arbitration of employment disputes with their executives through the following contractual language:

Arbitration. In the event there is a dispute arising under this agreement, the parties will submit their dispute to arbitration in New Orleans for final resolution in accordance with the rules and procedures of the American Arbitration Association. If [the executive] prevails, [the corporation] shall pay all costs incurred by him as a result of the arbitration.⁸³

Contractual language similar to that used by First Commerce Corporation of Louisiana could be added to executive indemnity agreements to ensure that such disputes are resolved through arbitration instead of settling conflicts through the costly and time consuming litigation process.

B. Charter or Bylaw Amendments

Corporations can amend their charters or bylaws to provide for the arbitration of indemnification disputes with their executives.⁸⁴ Courts have found that arbitration provisions in bylaws and organizational constitutions of private associations such as labor groups, religious groups, realty boards and securities exchanges are binding upon members, even if the members themselves have not signed any agreement to be bound by the organization's rules.⁸⁵ Both corporate charters and bylaws lay valid, contractual obligations on corporate executives. Therefore, the inclusion of

⁸² See Sanborn, *supra* note 33, at 350-351.

⁸³ *First Commerce Corp. Louisiana*, SEC Form S-4 (Aug. 1, 1995) available in WESTLAW, EDGAR database, FILING 95557951, at *495-496.

⁸⁴ Corporate charters are more difficult to amend than bylaws. Unless the charter amendment is a result of corporate reorganization, most charter amendments require the board of directors to recommend the adoption of the amendment, as well as the approval of shareholders. See REVISED MODEL BUSINESS CORP. ACT § 10.03 (1985). Corporate bylaws may be amended only by approval of the board of directors. See *id.* § 10.20.

⁸⁵ See Shell, *supra* note 27, at 546-547.

an indemnification arbitration provision in these corporate governing rules would establish an enforceable contract under the FAA.⁸⁶

At least one public corporation has included an indemnification dispute arbitration provision in its corporate bylaws.⁸⁷ Wisconsin Energy Corporation modified its bylaws to allow for arbitration in indemnification conflicts by providing that the director or officer seeking indemnification could have their right to indemnification determined by "a panel of three (3) arbitrators consisting of one arbitrator selected by those directors . . . entitled to select independent counsel, one arbitrator selected by the director or officer seeking indemnification and one arbitrator selected by the two (2) arbitrators previously selected."⁸⁸ Wisconsin Energy Corporation has apparently recognized the benefits of avoiding litigation of indemnification disputes.

More public corporations should follow the approach of Wisconsin Energy Corporation and develop arbitration as a mechanism for settling intracorporate indemnification claims.

V. BENEFITS OF ARBITRATING INDEMNIFICATION DISPUTES

Arbitration is thought to present three particularly distinct advantages over the litigation of intracorporate disputes: "(1) lower cost, (2) relative speed, and (3) expertise."⁸⁹

First, arbitration is generally thought to be less costly than full-scale litigation.⁹⁰ The simplicity of arbitration procedures, as compared to the

⁸⁶ See *id.* at 552. "[T]he individuals who govern the corporation . . . should be bound by any dispute resolution system provided for in the charter just as they must honor any charter rules determining the number of seats on the board, voting requirements for removal of directors, or other basic governance matters." *Id.*

⁸⁷ See Sanborn, *supra* note 33, at 353.

⁸⁸ *Wisconsin Energy Corp.*, SEC Form S-4 (Aug. 7, 1995), available in WESTLAW, EDGAR database, FILING 95559416 at *364-365. Wisconsin Energy Corporation's directors and officers are not required to arbitrate indemnification disputes but may instead opt to have their right to indemnification determined by (1) a majority vote of the Board of Directors who are not parties to the proceedings, or a committee appointed by the Board of Directors; (2) independent counsel selected by the Board of Directors or a selection committee; or (3) a vote of shareholders who are not parties to the underlying action. See *id.*

⁸⁹ Coffee, *supra* note 52, at 957.

⁹⁰ See GOLDBERG ET AL., *supra* note 8, at 200.

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complexity of trials and especially pre-trial discovery,⁹¹ would save money that could be directed toward the general corporate goal of increasing shareholder profits.⁹²

Arbitration is also considered to be a more speedy method of resolving disputes than litigation.⁹³ Faster resolution of indemnification fights would allow for the corporate directors and officers to expeditiously continue with the defense of the claims brought against them. If the indemnification determination can be made in a timely fashion, then the underlying claim will inevitably be closed in shorter course. Resolving the entire matter as quickly as possible would again derivatively serve the best interests of the shareholders by allowing corporate managers to focus their energies on the corporate operations instead of defending personal claims.

Another benefit of arbitration is that the arbitrators are likely to have more expertise than a court.⁹⁴ This benefit is even more likely to be present in a highly specialized area of law, such as director and officer indemnification.⁹⁵ Indeed, it is unlikely that outside the state of Delaware, the courts would have better expertise at determining matters involving corporate governance than arbitrators selected by the parties.⁹⁶ The American Arbitration Association (AAA)⁹⁷ is particularly skilled and experienced in handling complex corporate disputes.⁹⁸ The AAA has adopted special rules for handling complex securities matters that allow for the efficient and economical resolution of disputes with claims in excess of \$1,000,000.⁹⁹ In its quick response to the rush of securities arbitration, the

⁹¹ *See id.*

⁹² *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 2.01(a), at 69 (Proposed Final Draft March 31, 1992).

⁹³ *See* GOLDBERG ET AL., *supra* note 8, at 200.

⁹⁴ *See id.*

⁹⁵ *See* Coffee, *supra* note 52, at 957.

⁹⁶ *See id.*

⁹⁷ The AAA is a public service, nonprofit organization that was founded in 1926 to encourage the use of arbitration and other ADR mechanisms. It provides education, training and research on ADR, and assists industries in designing their own ADR systems. *See* ROBERT COULSON, BUSINESS ARBITRATION—WHAT YOU NEED TO KNOW 8 (Rev. 5th ed. 1993).

⁹⁸ *See* Sanborn, *supra* note 33, at 363–364.

⁹⁹ *See* SECURITIES ARBITRATION RULES 7 (American Arbitration Association 1993). The AAA ensures that securities arbitrators are skilled and informed with regard to current securities issues by requiring that they complete special training before arbitrating, as well as requiring that they attend periodic refresher courses. *See* AMERICAN ARBITRATION ASSOCIATION, A GUIDE FOR SECURITIES ARBITRATORS

AAA has shown that it has the necessary flexibility and expertise to adapt adequately to arbitrate corporate indemnification disputes.¹⁰⁰

Corporations that adopt arbitration provisions for resolving indemnification disputes will reap the benefits that arbitration renders over litigation. Such benefits will eventually fall where they rightfully belong—the shareholders' purses.

VI. PROPOSED INDEMNIFICATION LANGUAGE

An intracorporate indemnification arbitration provision should attempt to preserve the basic function of the judicial process by providing an expert, external monitoring body that is sufficiently distant from the participants to render a disinterested judgment.¹⁰¹ The proposed indemnity arbitration provision below attempts to maintain such a balance. The language is equally suitable for inclusion in an executive indemnity agreement, or as a charter or bylaw provision.

ARBITRATION OF INDEMNIFICATION DISPUTES

(1) Any dispute between the corporation and the director or officer arising out of or relating to the director or officer's right to indemnification, shall be discussed between the disputing parties in a good faith effort to arrive at a mutual settlement of any controversy. If such dispute cannot be resolved, at the insistence of any party, the dispute shall be submitted to binding arbitration.

(2) The director or officer seeking indemnification shall select one of the following two (2) means for conducting arbitration to determine his or her right to indemnification:

SERVING UNDER THE AAA'S SECURITIES ARBITRATION RULES, 1993 WL 495389, at *2 (1993). Further, the AAA has implemented a Large Complex Case Project that utilizes a limited panel of highly qualified and trained arbitrators, special procedural rules and administration by senior AAA staff. *See id.* at *3.

¹⁰⁰ The United States Supreme Court first approved arbitration of securities disputes in 1987. *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

¹⁰¹ *See Coffee, supra* note 52, at 957-958.

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(a) By a panel of three (3) arbitrators consisting of one arbitrator selected by a quorum of those directors who are not parties to the same or related proceedings, one arbitrator selected by the director or officer seeking indemnification and one arbitrator selected by the two (2) arbitrators previously selected; or

(b) By submission of the dispute to arbitration in the jurisdiction of incorporation for resolution in accordance with the rules and procedures of the American Arbitration Association.¹⁰²

Section 1 of the proposed indemnity arbitration provision attempts to ensure that the dispute between the party seeking indemnification and the corporation cannot be resolved through mutual agreement before requiring extracorporate involvement. The section attempts to conserve even the time and money that will be consumed if the parties avoid litigation and agree to arbitrate the dispute. Section 1 also recognizes the effectiveness of negotiation as a means of settling disputes and attempts to force a dialogue that may adequately resolve the conflict.¹⁰³

Section 2 of the proposed provision provides the party seeking indemnification a choice of arbitrator selection procedures. The executive may either choose to directly participate in the selection, or allow the AAA to provide arbitrators through their usual process.¹⁰⁴ Section 2 attempts to ensure that the most vulnerable party in a corporate indemnification dispute, the party seeking indemnification, maintains some command over the external decisionmaking body. This provision is needed to balance the strength that the proposal affords the corporate entity by permitting it to initiate the arbitration, even if the executive pursuing indemnification would prefer to litigate the matter.

¹⁰² This model provision combines elements of Article XI, § 1 of the NYSE Constitution, Wisconsin Energy Corporation's indemnification arbitration provision and Ciprico, Inc.'s restricted stock arbitration provision. *See Ciprico, Inc.*, SEC Form 10-Q (June 30, 1995) available in WESTLAW, EDGAR database, FILING 95559749, at *40-41.

¹⁰³ Negotiation is the primary means of resolving disputes. "Ninety-five percent of cases filed in court are resolved without a trial. Most disputes are never filed in court; instead, lawyers and business executives constantly negotiate." COULSON, *supra* note 97, at 13.

¹⁰⁴ If parties have not agreed upon arbitrators when a dispute is submitted to the AAA, the organization will prepare a list of proposed arbitrators based on the nature of the dispute. Each party has 10 days to raise objections to particular arbitrator candidates, and then the AAA selects mutually acceptable choices. *See id.* at 18-19.

The AAA maintains more than 55,000 neutral business experts who may serve as arbitrators. *See id.* at 15.

The above-proposed indemnity-arbitration provision, or other similar language, will preserve the basic functions of the judiciary in litigation.¹⁰⁵ It will provide an expert, external monitoring body that is distant enough from the parties to render a fair judgment.

VII. CONCLUSION

Based on the reasoning of the district court in *Salomon*, indemnification-arbitration provisions would be enforceable under the FAA's two part test. First, either through an arbitration provision in executive indemnity agreements or through charter or bylaw amendments, the corporation and its directors and officers would have agreed to arbitrate indemnification disputes. Further, there is an absence of external legal constraints that would prevent the arbitration of indemnification disputes. Therefore, public corporations should adopt provisions to arbitrate indemnification disputes in an effort to save time and money and fulfill the general corporate goal of increasing shareholder profits.¹⁰⁶

¹⁰⁵ Drafters of director and officer indemnification provisions should be aware that in a dispute, whatever contract provisions are omitted from their arbitration agreements will be filled by either local laws or rules of arbitration associations. See KNEPPER & BAILEY, *supra* note 2, at 329.

The drafters should always be careful to consider provisions relating to:

how jurisdictional disputes shall be determined, what relief may be granted by the arbitrator, the nature and extent of discovery to be permitted in the arbitration proceedings, whether any form of injunctive relief may be granted during the pendency of the proceedings, whether the arbitrator may award punitive damage and any limitations or guidelines as the determination of compensatory damages.

Id. at 329-330.

¹⁰⁶ See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 2.01(a), at 69 (Proposed Final Draft March 31, 1992).